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FEDERAL COMMUNICATIONS COMMISSION
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FILE

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D. C. 20554

In the Matter of	)	CC Docket No. 92-101
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers' Accounting for Postretirement Benefits Other Than Pensions"	)	
Bell Atlantic Tariff F.C.C. No. 1	)	Transmittal No. 497
US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4	)	Transmittal No. 246
Pacific Bell Tariff F.C.C. No. 128	)	Transmittal No. 1579

DIRECT CASE OF THE
NYNEX TELEPHONE COMPANIES

New England Telephone And
Telegraph Company

and

New York Telephone Company

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Dated: June 1, 1992

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SUMMARY

This Direct Case by the NYNEX Telephone Companies (NTCs) shows that the Commission should grant an exogenous change to the price cap index levels to recover additional costs arising from implementation of Statement of Financial Accounting Standards No. 106 (SFAS 106) -- "Employers' Accounting for Postretirement Benefits Other Than Pensions" (OPEBs). SFAS 106 essentially requires accrual instead of pay-as-you-go accounting with respect to OPEB expenses. We also provide all the information and documentation requested by the FCC's Common Carrier Bureau in its designation order.

First, this accounting change is beyond the control of the NTCs. The Commission required the NTCs to implement SFAS 106 accounting for regulatory purposes no later than January 1, 1993.

Second, about 84.8% of the NTCs' additional costs from this accounting change will not be captured in the GNP-PI. Given that this change is largely unreflected in the price cap formula, the FCC should permit the NTCs to recover at least 84.8% of those additional costs. Our primary evidence showing the affect on the GNP-PI consists of the Godwins study (attached). The Godwins study finds that, ultimately, the increase in GNP-PI caused by SFAS 106 (.0124%) will provide for recovery of 0.7% annually of the SFAS 106 costs incurred by Price Cap LECs. Other macroeconomic factors, principally the

eventual downward adjustment of the national wage rate, will account for recovery of a further 14.5% of the additional costs incurred by Price Cap LECs, leaving 84.8% of these costs unrecovered, according to Godwins.

No other mechanism in the price cap system has afforded or will afford the NTCs recovery of SFAS 106-type accrued OPEB expenses. Moreover, exogenous treatment of the SFAS 106 implementation costs would further the FCC's theories underlying its price cap regime. These costs represent a permanent change beyond the NTCs' control for which recovery is needed for reasonable rates. Therefore, exogenous treatment is appropriate under the FCC's rules. After SFAS 106 cutover, the price cap rules will give the NTCs every incentive to continue improving their efficiency and productivity in managing the underlying OPEB costs.

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DIRECT CASE OF THE NYNEX TELEPHONE COMPANIES

I. INTRODUCTION

New England Telephone and Telegraph Company and New York Telephone Company (the NYNEX Telephone Companies or NTCs) submit this Direct Case in response to the Order of Investigation And Suspension (OIS) released on April 30, 1992, by the Chief, FCC Common Carrier Bureau in the above-captioned matter. As shown herein, the Commission should grant the NYNEX Telephone Companies an exogenous change to price cap index levels to recover the additional costs arising from implementation of Statement of Financial Accounting Standards No. 106 (SFAS 106) --

"Employers' Accounting for Postretirement Benefits Other Than Pensions."

II. BACKGROUND AND ISSUES

A. SFAS 106 Accounting Change

-- FASB Adoption of SFAS 106: In December 1990, the Financial Accounting Standards Board (FASB) issued SFAS 106, which changes the way companies subject to Generally Accepted Accounting Principles (GAAP) -- including the NTCs -- must financially account for postretirement benefits other than pensions (OPEBs).[1] Although OPEBs include all non-pension postretirement benefits, in the NTCs' case, OPEBs mainly consist of medical benefits. SFAS 106 accounting is required for fiscal years beginning after December 15, 1992, with earlier implementation encouraged.

At present, the NTCs account for OPEBs on a "pay-as-you-go" basis, which reflects amounts actually paid to or for retirees each year. SFAS 106 changes this accounting by requiring that OPEBs be accounted for on an accrual basis which recognizes OPEBs as a form of deferred compensation earned by employees as they provide service to the employer.[2]

Under SFAS 106, the amount accrued as the cost of OPEBs for a period is the "Net Periodic Postretirement Benefit Cost" and the components are defined as follows:

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1 See OIS para. 2.

2 See SFAS 106 Summary.

(1) <u>Service Cost</u>: This component represents the portion of the Expected Postretirement Benefit Obligation ("EPBO"), earned by employees during the current accounting period. The EPBO is the actuarial present value as of a particular date of the benefits expected to be paid to or for an employee, the employee's beneficiaries, and any covered dependents pursuant to the terms of the postretirement benefit plan.

(2) <u>Interest Cost</u>: This component is the product of the assumed discount rate times the beginning of the year accumulated postretirement benefit obligation ("APBO"). The APBO represents the portion of the EPBO earned to date as a result of past employee service. Interest cost represents the increase in discounted plan liabilities that occur as a result of the passage of time.

(3) <u>Actual Return on Plan Assets</u>: This component represents the return on plan assets permanently set aside to satisfy future plan obligations and is a reduction to the net periodic postretirement benefit cost.

(4) <u>Amortization of Unrecognized Prior Service Costs</u>: This component represents the ratable recognition of the cost of plan amendments that increase or decrease benefits attributable to prior periods.

(5) <u>Amortization of Gain or Loss Deferred</u>: This component represents the ratable recognition of the net effects of prior years' unrecognized gains and losses. Gains and losses may be either changes in the amounts of the APBO or the plan assets that have resulted from experience different from that assumed or from changes in assumptions.

(6) <u>Amortization of the Transition Obligation</u>: This component represents the ratable amortization of the unrecognized net OPEB obligation or asset existing at the initial

> application date of the final standard.[3]

--<u>The FCC's Adoption of SFAS 106</u>: Section 32.16 of the FCC's Rules[4] provides in relevant part:

> The company's records and accounts shall be adjusted to apply new accounting standards prescribed by the Financial Accounting Standards Board or successor authoritative accounting standard-setting groups, in a manner consistent with generally accepted accounting principles. Commission approval of a change in accounting standard will automatically take effect 90 days after the company informs this Commission of its intention to follow the new standard, unless the Commission notifies the company to the contrary.

This rule effectuates the Commission's prior determination that GAAP changes shall be incorporated into the Uniform System of Accounts (USOA) unless the Commission decides that regulatory considerations dictate otherwise.[5] As described in the OIS: "Pursuant to Section 32.16, the Bureau issued an Order authorizing all subject carriers to adopt SFAS-106, on or before January 1, 1993, as a mandatory practice for purposes of the USOA."[6] That Order by the Common Carrier Bureau provided

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3 SFAS 106, paras. 89 to 93; Responsible Accounting Officers (RAO) Letter 20, released May 4, 1992 (DA 92-520) by Chief, Accounting and Audits Division.

4 47 C.F.R. Section 32.16, entitled "Changes in accounting standards."

5 <u>Revision of USOA For Telephone Companies To Accommodate GAAP</u>, CC Docket No. 84-469, Report and Order released November 14, 1985, 102 FCC2d 964 (GAAP Order).

6 OIS para. 3, citing <u>Southwestern Bell and GTE Service Corp. -- Notification of Intent to Adopt SFAS 106</u>, AAD 91-80 (DA 91-1582), Order by Chief, FCC Common Carrier Bureau released December 26, 1991.

that (para. 3): "After reviewing SFAS-106, we have concluded that its adoption for accounting purposes will not conflict with the Commission's regulatory objectives." Regarding the transition obligation, the Bureau (at para. 4) "direct[ed] the carriers to defer and amortize the embedded liability in accordance with SFAS-106."[7]

B. Procedural Background Of The Present Order Of Suspension And Investigation

The Bell Atlantic Telephone Companies, U S WEST Communications, Inc. and Pacific Bell have filed interstate tariffs seeking exogenous treatment for the incremental costs of implementing SFAS 106.[8] The OIS has suspended the Bell Atlantic and U S WEST tariffs for five months.[9]

The OIS observed that (para. 9): "the issue of the exogenous treatment of the costs associated with implementing SFAS-106 appears to be similar for all LECs [Local Exchange Carriers] subject to price caps." Accordingly, the OIS established this proceeding to resolve that issue. It made all price cap LECs -- including those like the NTCs who have not yet filed for SFAS 106 exogenous treatment -- parties to the proceeding and it required every LEC to file a Direct Case.[10]

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7 <u>See</u> also RAO Letter 20 released May 4, 1992, <u>supra</u>, p. 1.

8 <u>See</u> OIS para. 1.

9 OIS para. 25. The OIS did not suspend the Pacific Bell tariff since the Bureau anticipates that the issues raised for investigation will be resolved prior to the January 1, 1993 effective date of that tariff. <u>Id</u>. at n. 3.

10 <u>Id</u>. at para. 9 & n. 12.

In paragraphs 10-16, the OIS designated the issues for investigation and directed the LECs to present their positions on these issues. The NTCs do so in Sections III and IV of this filing.

C. FCC Price Cap Rules In Relation To Changes In GAAP

Effective January 1, 1991, for subject LECs, the Commission established a price cap system of rate regulation designed to foster incentives for carriers to be more efficient and productive than a benchmark measure of cost changes.[11] The benchmark against which each carrier's performance is measured is embodied in the Price Cap Index (PCI), which limits carrier prices.[12] The PCI has three components. The first is a measure of inflation, the Gross National Product Price Index (GNP-PI).[13] The second is a productivity offset, "selected on the basis of the amount by which LEC productivity growth has historically exceeded productivity for the economy generally," which is subtracted from the inflation element.[14] The third component of the PCI consists of exogenous costs.[15]

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11 See OIS para. 5 and n. 2.

12 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Lec Price Cap Reconsideration Order, released April 17, 1991, 6 FCC Rcd 2637, para. 20.

13 LEC Price Cap Reconsideration Order at para. 4.

14 Id.

15 Exogenous costs are in general those costs that are triggered by administrative, legislative or judicial

(Footnote Continued On Next Page)

Under FCC price cap rules, if a GAAP change has been ordered by the FCC to be reflected in regulatory accounting, exogenous treatment should be granted to the extent there would be no double-counting in the GNP-PI.

With respect to GAAP changes, the Commission has stated that carriers must notify the FCC of their intent to adopt such changes:

> [C]arriers are not authorized to adjust their price caps automatically to reflect changes in generally accepted accounting principles (GAAP).... Carriers must notify us of their intention to apply a change in GAAP and we will allow such change if we find it to be compatible with our regulatory accounting needs. No carrier may adjust its price caps to reflect a change in GAAP until we have approved the carrier's proposed change.[16]

Furthermore, in the LEC Price Cap Reconsideration Order, the Commission declared with respect to OPEBs and SFAS 106:

> [N]o carrier could treat GAAP changes as exogenous until we approved the change, and

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15 (Footnote Continued From Previous Page)

action beyond the control of the carriers.... [T]hese are costs that should result in an adjustment to the cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates." CC Docket No. 87-313, LEC Price Cap Order, released October 4, 1990, 5 FCC Rcd 7664, para. 166; OIS para. 5.

16 LEC Price Cap Order, para. 168. See also: FCC Rule 61.45(d); AT&T, Transmittal No. 2304, Order released June 27, 1990 (DA 90-878), para. 4 ("[T]he accounting change AT&T seeks to claim as exogenous [SFAS 106] will probably be mandated by FASB in 1992, and at that time qualify for exogenous treatment.... [E]xogenous costs [associated with USOA changes] can be either cost changes resulting from a change in [FCC] accounting rules or in any Commission-approved change in GAAP.").

> ... exogenous treatment would not be granted until FASB had actually approved a change in GAAP, and the change became effective.... Further, the test of whether to grant exogenous treatment of GAAP changes is not restricted to whether the change is outside the control of the carrier.... [T]he determination of whether a particular GAAP change is exogenous includes an analysis of whether the cost change will be reflected in the inflation variable of the PCI. If a GAAP change is universal enough to be reflected in the inflation measure, exogenous cost treatment would result in double counting within the context of the PCI.[17]

Finally, the Commission has emphasized that:

> GAAP changes should be eligible for exogenous treatment after a case-by-case review indicates that the change will not be adequately reflected in the GNP-PI.[18]

Since the Bureau has already authorized all subject LECs to implement SFAS 106 on or before January 1, 1993, the only issue with regard to exogenous treatment is whether this change will be adequately reflected in the GNP-PI. The NTCs will demonstrate in the following sections that the SFAS 106 change will not be fully recovered in the GNP-PI and that exogenous cost adjustments are warranted.

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17 LEC Price Cap Reconsideration Order, paras. 59, 63; OIS para. 6.

18 CC Docket No. 87-313; AT&T Price Cap Reconsideration Order, released February 8, 1991, 6 FCC Rcd 665, para. 75, cited in LEC Price Cap Reconsideration Order at para. 63 and n. 68.

III. NYNEX TELEPHONE COMPANIES' POSITION (OIS Para. 10)

This section provides an overview of the NTCs' positions on the various designated issues in OIS para. 10; further details are furnished in Section IV:

> -- OIS para. 10.I: "Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change under the Commission's price cap rules?"

-- NTCs' Response: Yes. In this filing the NTCs provide evidence to clearly demonstrate that the additional costs of SFAS 106 implementation should be deemed exogenous under the Commission's price cap rules. First, this accounting change is beyond the control of the NTCs. The NTCs have been ordered by the Commission to implement SFAS 106 accounting for regulatory purposes by January 1, 1993. When issuing SFAS 106, the FASB also required adoption by January 1, 1993 for financial accounting purposes.

Second, about 84.8% of the NTCs' additional costs from this accounting change will not be captured in the GNP-PI. Hence, the FCC should permit the NTCs to recover at least 84.8% of those additional costs. Our primary evidence showing that this level of additional costs is not reflected in the GNP-PI consists of the Godwins study (described infra and attached hereto -- Attachment A). The Godwins study (at p. 1):

> finds that ultimately the increase in GNP-PI caused by SFAS 106 (.0124%) will provide for recovery of 0.7% of the additional costs incurred by Price Cap LECs. Other macroeconomic factors, principally the eventual adjustment of the national wage rate, account for recovery of

> an additional 14.5% of the additional costs incurred by Price Cap LECs, leaving 84.8% of these additional costs unrecovered.

-- <u>OIS para. 10.II</u>: "If these cost changes are treated as exogenous, (a) Should costs associated with implementation of SFAS-106 prior to January 1, 1993 (when the accounting change becomes mandatory) be treated as exogenous?"

-- <u>NTCs' Response</u>: We have not finally determined whether to implement SFAS 106 prior to January 1, 1993. We will abide by RAO Letter 20 (p. 1) which requires the NTCs to provide the Commission with 30 days written notice of when we will adopt SFAS 106 for regulatory accounting purposes.

Should the NTCs start applying SFAS 106 for regulatory purposes for calendar year 1992, exogenous treatment for 1992 would still be appropriate since: SFAS 106 is effective for fiscal years beginning after December 15, 1992 -- however, earlier application is encouraged;[19] and the Common Carrier Bureau has determined that "to implement SFAS-106 on or before January 1, 1993 will not conflict with [the FCC's] regulatory objectives."[20]

-- <u>OIS para. 10.II.b</u>: "Are the assumptions made by the individual LECs in calculating these costs reasonable?"

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19 SFAS 106, para. 108.

20 <u>Southwestern Bell and GTE Service Corp. Notification of Intent to Adopt</u>, <u>supra</u>, AAD 91-80, Order released December 26, 1991, para. 3. <u>See</u> also <u>LEC Price Cap Reconsideration Order</u>, para. 61 ("Carriers that chose to accrue OPEB expenses were not more 'right' or 'wrong' than carriers that chose to await the GAAP change.")

-- <u>NTCs' Response</u>: Yes. The NTCs have not yet filed their tariffs seeking exogenous treatment with respect to SFAS 106. The OIS (n. 14) provides: "Those price cap LECs who have not yet filed tariffs implementing SFAS-106 should submit good faith estimates of the costs outlined in (2) and (3) of this Section." Accordingly, the NTCs provide herein their best estimates, in the form of a range, of OPEB costs under SFAS 106.[21] By its very nature, identifying OPEB costs entails projections of future costs which rely on assumptions about employee force levels, service periods, retirement periods, benefit amounts, inflation, return on plan assets, etc. All these assumptions are fully documented and justified herein.

> -- <u>OIS para. 10.II.c</u>: "Given these assumptions, have the individual LECs correctly computed the exogenous cost changes?"

-- <u>NTCs' Response</u>: Yes. Again, the range is a good faith estimate since the NTCs have yet to file tariffs regarding SFAS 106.

> -- <u>OIS par. 10.II.d</u>: "Are the individual LEC allocations of these costs among the price cap baskets consistent with Commission rules?"

--<u>NTCs' Response</u>: Yes. FCC Rule 61.45(d)(4) requires exogenous cost changes to be apportioned on a "cost-causative basis" to price cap services and baskets. We will apportion the additional regulated interstate revenue requirements for

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21 <u>See also</u> Attachment B.

SFAS 106 costs based upon wage-related expenses, to which OPEBs have a cost-causative relation.

* * * * *

In sum, the NYNEX Telephone Companies have justified an exogenous change to Price Cap Index levels to recover at least 84.8% of additional interstate costs of SFAS 106 accounting for OPEBs. The additional interstate revenue requirements for the NYNEX Telephone Companies for 1993 are anticipated to range from a low of $45 million to a high of $101 million. These represent good faith estimates based upon present knowledge, and are depicted in more detail in Attachment B.[22] When the NTCs file interstate tariffs with respect to SFAS 106, of course, they will not include a range, but will reflect the final implementation options and assumptions selected by the NTCs pursuant to SFAS 106.

IV. NYNEX TELEPHONE COMPANIES' RESPONSES TO OIS PARAS. 11-16

A. OIS Para. 11.1:

> "provide ... the date the LEC has implemented or intends to implement SFAS-106."

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22 Attachment B also includes an analogous range if the NTCs adopt SFAS 106 for the calendar year 1992.

The NYNEX Telephone Companies intend to implement SFAS 106 on or before January 1, 1993. A final decision on this timing has not yet been made. As per RAO Letter 20 (p. 1), we will provide the Commission with 30 days written notice of when we will adopt SFAS 106 for regulatory accounting purposes.

B. OIS Para. 11.2: "provide ... the costs by year."

Pursuant to OIS n. 14, since the NTCs have not yet filed their interstate tariffs relative to SFAS 106, we provide (in Attachment B herein) good faith estimates of the costs of implementing SFAS 106 in 1992-93. These estimates reflect NYNEX health care and dental postretirement benefit programs. The data reflects a 20-year amortization of the transition obligation. The various assumptions, plan provisions, and employer benefit costs used to project OPEB costs under SFAS 106 are supplied in Attachment H. For 1993, the additional interstate revenue requirements for the NTCs arising from SFAS 106 implementation are projected to range from a low of $45 million up to a high of $101 million. These figures are for the regulated portion of the NTCs' business only; none of the effects of SFAS 106 on nonregulated portions of the business are reflected.

C. OIS Para. 11.3:

"provide ... the allocation of costs to baskets by year."

Section 61.45(d)(4) of the Commission's rules provides:

> Exogenous cost changes shall be apportioned on a cost-causative basis between price cap services as a group, and excluded services as a group. Exogenous cost changes thus attributed to price cap services shall be further apportioned on a cost-causative basis among the price cap baskets.

The NYNEX Telephone Companies propose to allocate the additional regulated interstate revenue requirements for SFAS 106 costs across baskets based on expense data from ARMIS reports. The allocation will be based on each basket's proportion of Total Operating Expense less Depreciation and Amortization. This method captures the sum of Plant Specific, Plant Non-specific, Customer Operations - Marketing, Customer Operations - Services, and Corporate Operations expense, as allocated under Part 36 and Part 69 of the FCC's rules and reported on the 1991 ARMIS 43-01 Report, but excludes the non-labor related depreciation and amortization expenses. The expense categories used in the allocation include the accounts that will be used to record OPEBs, and therefore are appropriate for apportioning OPEB costs. This allocation meets the Commission's requirement for a "cost-causative" allocation among price cap baskets.

Based on the above allocation method, Attachment C hereto presents the development of the allocation factors using ARMIS 43-01 data and the allocation of estimated SFAS 106 regulated interstate revenue requirement across the price cap baskets reflecting scenarios for adoption in both 1992 and 1993.

D. <u>OIS Para. 11.4</u>:

> "provide ... the treatment of these costs in reports to the Securities and Exchange

> Commission (SEC) and to shareholders, including specific citations to, or excerpted materials from, such reports."

Included in Attachment D are copies of the disclosures relating to SFAS 106 provided in the NYNEX Telephone Companies' Form 10-K filings with the SEC for the year ended December 31, 1991, and in the NYNEX Corporation 1991 Annual Report.

E. OIS Para. 11.5:

> "provide ... all studies on which the LEC seeks to rely in its demonstration that these accounting changes should be considered exogenous cost changes, including all studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, initial price cap rates, and the sharing and low-end formula adjustment mechanisms."

1. Factors For Inflation: In this filing, the NYNEX Telephone Companies place primary reliance on the Godwins study (entitled "Analysis of Impact of FAS 106 Costs on GNP-PI" and dated February 18, 1992)[23] as evidence that at least 84.8% of SFAS 106 implementation costs will not be reflected in the inflation factor in the price cap formula (GNP-PI). That study was commissioned by the United States Telephone Association (USTA) and supported by the NTCs.

Godwins, Inc. performed a study to determine what portion of the additional costs recorded as a result of implementing SFAS 106 incurred by Price Cap LECs will be

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23 Included in Attachment A.

reflected in the GNP-PI. The study is presented in two stages: an Actuarial Analysis and a Macroeconomic Analysis.

The Actuarial Analysis uses a composite company ("TELCO") comprised of demographic, economic and benefit program data from each Price Cap LEC. TELCO reflects the characteristics of that part of the industry subject to price caps. A key result of the Actuarial Analysis is that Price Cap LECs will incur a disproportionate share of the SFAS 106 implementation cost burden. The following steps led to this conclusion:

- Determining how TELCO's program compared to an average benefit program by utilizing data from retiree medical plans sponsored by 830 private sector employers and Godwins' Benefit Level Indicator methodology (which indicates proportion of charges met).

- Adjusting this comparative benefit analysis to reflect specific factors that would generate different levels of SFAS 106 costs (e.g., number and impact of current retirees, demographics, withdrawal and retirement patterns).

- Taking into account the large group of workers in the national economy not covered by any postretirement benefit program, or who are covered by programs not affected by the FASB's rules. These workers' employers will incur no SFAS 106 costs for them.

- Making two final adjustments to the comparative analysis due to economic factors: for differences between per unit labor costs for TELCO and for other employers; and for differences in the percentage of total output represented by labor costs for TELCO and other employers.

Specifically, Godwins concludes that the impact of SFAS 106 on the average employer is only 28.3% of the effect on the average Price Cap LEC. Additionally, the Actuarial Analysis finds that SFAS 106 directly increases labor costs by 3% for the average employer offering postretirement health benefits covered by SFAS 106. This figure is an important input to the Macroeconomic Analysis.

The purpose of the Macroeconomic Analysis is to determine the extent to which additional costs resulting from SFAS 106 would be passed through to an increase in GNP-PI. This Analysis utilizes a model developed for Godwins by Professor Andrew Abel of the Wharton School of the University of Pennsylvania, to address this question. The impact of SFAS 106 is shown as a direct increase of 3% in the cost of labor for employers who offer postretirement health benefits. The Macroeconomic Analysis finds that only 2.3% of the average employer's additional costs (resulting from SFAS 106) will be passed through to the GNP-PI. In addition, due to SFAS 106, the average wage rate in the economy will be .93% lower than it would have been in the absence of SFAS 106.

Godwins summarizes the effects of SFAS 106 on TELCO's costs as follows (p. 2):

(A)	Impact on national average costs relative to TELCO's costs (from the Actuarial Analysis)	28.3%
(B)	Proportion of increase in national average costs passed through to GNP-PI (from the Macroeconomic Analysis)	2.3%
(C)	Proportion of TELCO's SFAS 106 cost increase reflected in GNP-PI (item (A) x item (B))	0.7%
(D)	Proportion of TELCO's SFAS 106 cost increase offset by other macroeconomic adjustments, including the reduction of the wage rate (from the Macroeconomic Analysis)	14.5%

(E) Proportion of TELCO's SFAS 106 cost increase unrecovered (100% - item (C) - item (D)) 84.8%

The Godwins study concludes that the increase in GNP-PI caused by SFAS 106 (.0124%) will ultimately provide for recovery of 0.7% of additional costs incurred by the Price Cap LECs. That is, only 0.7% of the SFAS 106 costs will be reflected in the GNP-PI, and 99.3% of these additional costs will not be reflected. Other macroeconomic factors, primarily an eventual downward effect on the national wage rate, will account for recovery of another 14.5% of additional costs incurred by Price Cap LECs. This will leave 84.8% of additional costs unrecovered.

This study used conservative assumptions throughout, to avoid understating the impact of GNP-PI and overstating the cost impact on the LECs. The results of the Godwins study demonstrate that a majority of SFAS 106 costs should be classified as exogenous under the Commission's price cap rules.

This central conclusion of the Godwins study is buttressed by a study, submitted with Pacific Bell's tariff, entitled "The Treatment Of FAS 106 Accounting Changes Under Price Cap Regulation," dated April 15, 1992, and prepared by the National Economic Research Associates, Inc. (NERA). The NERA study observes (pp. 2-3):

> Our conclusions support exogenous cost treatment for FAS 106 cost changes. First, we find that adoption of accrual accounting for postretirement benefits represents an accounting recognition of proper economic costs. Prices under price caps were initially set using cash accounting for postretirement benefits. Thus a change in the price cap is necessary so that prices

> will reflect the economic cost of service. Second, adoption of FAS 106 accounting by the FASB and by the FCC is certainly beyond the control of the regulated firm. Moreover, a one-time adjustment to its prices to reflect the economic costs of postretirement benefits does not reduce the firm's incentive to control expenditures on those benefits. Third, because prices in unregulated markets already reflect the economic costs of postretirement benefits, adoption of FAS 106 will not cause them to change. Hence the effect of FAS 106 on output prices is confined to the regulated sector, and we estimate its effect on the rate of growth of GNP-PI to be less than 0.12 percent per year.

2. Factors For Productivity: The productivity offset factor in the price cap formula does not reflect SFAS 106 implementation costs.

In setting the LEC productivity factor, the FCC considered the two studies by its staff on short-term and long-term measures of historical productivity, respectively. The FCC selected a figure within the range between the long-term pre-divestiture study result and the short-term post-divestiture study result.[24] The short-term study calculated a productivity offset utilizing costs, demand and revenues for 1984 through 1990, while adjusting for some exogenous factors. In computing rates, revenues were adjusted for exogenous changes which would have been reflected in the price cap index for both the common line and traffic sensitive baskets. Although the study accounted for several exogenous items, including the revised treatment of pension expenses,

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24 LEC Price Cap Order, paras. 74, 97-99.

there was no accounting made for revised treatment of OPEB expenses.[25] Indeed, SFAS 106 was not even issued until after the FCC adopted the price cap plan.

The long-term study measured productivity indirectly for the years 1928 through 1989. Although it encompassed a range of economic conditions, it did not adjust for exogenous cost changes since divestiture.

3. Allowed Exogenous Changes: With respect to the NTCs, SFAS 106 implementation costs are not reflected in any of the previously allowable exogenous cost changes. Under FCC price cap regulation, costs are eligible for exogenous treatment if they are triggered by administrative, legislative or judicial action beyond the control of carriers.[26] FCC Rule 61.45(d) specifies exogenous treatment for LEC cost changes as permitted or required by the Commission.

- completion of the amortization of depreciation reserve deficiencies;
- changes in the Uniform System of Accounts permitted or required by the Commission;
- changes in the Separations Manual;
- changes to the level of obligation associated with the Long Term Support Fund and the Transitional Support Fund;
- reallocation of investments from regulated to nonregulated activities;
- tax law changes and other extraordinary exogenous cost changes as permitted or required by the Commission;

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25 *Id*. at paras. 77, 85, 90 and Appendix C (Frentrup/Uretsky Study), paras. 5-6.

26 LEC Price Cap Reconsideration Order, para. 58.

- retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark;
- inside wire amortization; and
- effectuation of the price cap sharing mechanism.

As noted previously, cost changes arising from GAAP changes are eligible for exogenous treatment pursuant to Commission approval.[27]

The NTCs have not yet made any exogenous changes to reflect OPEB expense accruals that will be made under SFAS 106. Moreover, the subject matters of the above-listed items are such that none would include the impact of SFAS 106. SFAS 106 has no impact on reserve deficiency or inside wire amortizations. No amendments have been made to the USOA as a result of SFAS 106 adoption.[28] And, SFAS 106 implementation has not impacted the Separations Manual, transitional and long term support, reallocation of regulated versus nonregulated costs, tax changes, low end adjustments or the price cap sharing mechanism.

4. Initial Price Cap Rates: The NTCs' initial price cap rates did not capture the impact of SFAS 106. The NTCs used their July 1, 1990 rates as the basis for their inaugural price cap filing.[29] At that time (as today), the NTCs

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27 LEC Price Cap Reconsideration Order, para. 59.

28 See LEC Price Cap Reconsideration Order, para. 61; RAO Letter 20.

29 See LEC Price Cap Order, para. 17.